

Corporate Finance, Module 24: “Financial Analysis and Planning”

Corporate finance module 24: Readings for Tenth Edition

(The attached PDF file has better formatting.)

Updated: October 14, 2010

The page numbers here are for the *tenth* edition of Brealey and Myers. You may also use the seventh, eighth, or ninth editions of this text. The page numbers for earlier editions are in separate postings. The substantive changes in the textbook are slight among these editions, but the final exam problems are based on the tenth edition.

{The Brealey and Myers textbook is excellent. We say to read certain sections and to skip others. This does not mean that certain sections are better; it means that the homework assignments and exam problems are based on the sections that you must read for this course. Some of the skipped sections are fascinating, but they are not tested.}

Section 28.1 is an introduction that is not required for this course. If you have never had an accounting course and have not picked up basic accounting at work, then read this section. It introduces the financial statements (balance sheet and income statement). The module for the corporate finance VEE course deals with accounting ratios; it assumes you know what the income statement and balance sheet are. Many actuarial candidates are excellent theorists and first rate mathematicians, but they get lost on a balance sheet.

Read section 28.2, “Lowe's Financial Statements” on pages 705-708. A firm has three major financial statements: the balance sheet, the income statement, and the sources and uses of funds. Financial statements *articulate*, meaning that various relations hold among them. For example, a debit or a credit can appear on the balance sheet or the income statement, and the form in which it appears affects the change in equity over the year.

As you study this chapter from the Brealey and Myers text, look at the financial statements of your employer (or of a client, if you work for a consulting firm). You learn insurance accounting for the actuarial exams; mastery of this module will save you hours later on.

Read section 28.3, “Measuring Lowe's Performance,” on pages 708-713. This module covers the ratios in Table 28.6 on page 720. After reading each sub-section, come back to this table, find the figures in the three financial statements, and be sure you understand how the ratio is formed.

Insurers have similar ratios; the NAIC has IRIS ratios that determine whether an insurer must undergo a financial examination. The insurance ratios differ from the ratios in Table 29.4 because reserve requirements are the crux of insurance solvency. Non-insurers don't have reserves, and insurers don't have the basic building blocks of most other firms, such as inventories and fixed assets. But the concepts are the same for insurers and other firms.

Review problem 4(c) and 4(d) on page 725. Economic value added and return on capital use the capital at the beginning of the year (or the capital at the end of the previous year). Some analysts use the average capital during the year; don't do this on the final exam.

Review problem 25 on page 729. The tax shield is deducted from the weighted average cost of capital, so it must be deducted from income. Simply deducting the cost of equity from net income does not give the same result if book and market values of debt differ.